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PACIFIC TELESIS
Group-Washington

February 14, 1997

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, DC 20554

Dear Mr. Caton:

Re: *CC Docket No. 96-262, Access Charge Reform; CC Docket No. 94-1, Price Cap Performance Review for Local Exchange Carriers; CC Docket No. 91-213, Transport Rate Structure and Pricing; CC Docket No. 96-263, Usage of the Public Switched Network by Information Service and Internet Access Providers*

On behalf of Pacific Telesis Group, please find enclosed an original and twelve copies of its *"Reply Comments"* in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Jay Bennett

Enclosures

cc: ITS (w/ diskette)
Competitive Pricing Division (2 copies)
Chairman Hundt, Commissioners Quello, Ness, Chong

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

DOCKET FILE COPY ORIGINAL

In the Matter of	
Access Charge Reform	CC Docket No. 96-262
Price Cap Performance Review for Local Exchange Carriers	CC Docket No. 94-1
Transport Rate Structure and Pricing	CC Docket No. 91-213
Usage of the Public Switched Network by Information Service and Internet Access Providers	CC Docket No. 96-263

REPLY COMMENTS OF PACIFIC TELESIS GROUP

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Date: February 14, 1996

SUMMARY

LECs must be able to recover the real costs of doing business. Opponents argue that prices should be based on forward looking costs, ignoring those costs that a LEC truly incurs. Those opponents are simply trying to make their costs of doing business fall, while making the LEC shoulder the entire burden of universal service and other subsidies. The Commission must not accede to these demands. Subsidies present in the current system must not be disproportionately placed on one industry player. This means that purchasers of access, and unbundled elements must share in the subsidy elements of access.

Near unanimous agreement was present in the comments that the rate structure should change to better reflect cost causation principles. The rate structure of access should be changed as we have suggested in our comments.

A prescriptive approach should be rejected. TELRIC pricing is unfair and will not lead to a competitive market. The Commission should adopt the market based approach we suggested in our comments.

Pacific's financial integrity and its ability to attract capital will be threatened if the Commission does not establish coordinated separations, access charge, and universal service mechanisms which give ILECs the opportunity to recover their costs. The Commission's TSLRIC and TELRIC-based pricing do not include all existing costs, but rather are based on a hypothetical network which is necessarily more efficient than any existing network, because no ILEC immediately retires all operating equipment as soon as more efficient equipment is available.

The Commission has already disposed of the "price squeeze" red herring. The Commission found that an attempted price squeeze is unlikely to be an effective anti-competitive tool because competitors can purchase unbundled network elements and resale of retail services.

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REPLY COMMENTS OF PACIFIC TELESIS GROUP

I. INTRODUCTION

The comments in this docket exhibit our competitors' attempts to shape a marketplace where they have all the benefits and we have all the burdens. Without taking care of the very real costs contained in our rates, many of which are there as a direct result of regulatory fiat, change can only occur at the expense of the local exchange carriers, who are left bearing the burden of a half century's subsidies. The Commission must endorse an access reform process which fairly compensates LECs for their network and does not allow our competitors a free (or almost free) ride. Attached to these Reply Comments is an "Analysis of Subsidy, Access Reform and Universal Service" prepared by Rex Mitchell of Pacific Bell which outlines the dynamics of subsidy and telecommunications policy.

The IXCs and CLCs who want to immediately bring our access rates to TELRIC[1] are simply trying to avoid their share of the universal service burden. Universal service is not a LEC-specific problem. It is an industry problem which must be solved. Until the Commission recognizes that the universal service fund must be structured to handle all existing subsidies, subsidies will continue to plague the development of competition.

MCI claims that "[i]f access remains above cost, MCI and the other long distance carriers will be subsidizing the business of our soon-to-be rivals, the incumbent LECs."[2] MCI evidently believes that actual costs of business need not be passed through to customers of the business. Instead, so their argument goes, only forward looking costs should be recovered.[3] To the extent that costs are incurred by a business, whether as a result of regulatory determination (such as separations allocations) or a result of the configuration of its network, that business should be permitted to recover those costs in its prices. The fact that a business's prices recover more than forward looking cost does not mean that the business's rates need to be slashed.[4] In fact, as many economists agree, using only TELRIC pricing ignores shared and common costs, without recovery of which firms with economies of scope and scale cannot recover their costs.[5]

In the Interconnection docket, Drs. Alfred Kahn and Timothy Tardiff filed a declaration refuting the argument (also put forward in the Comments in this proceeding) that input prices must be based on a TSLRIC standard. Pricing inputs on a TSLRIC basis would exclude at least four other categories of costs:

> a. ongoing costs or burdens asymmetrically borne by the LECs but not their challengers by virtue of such public utility obligations as providing services-particularly basic telephone service to residential customers and particularly in rural areas-at rates below economically efficient levels, the consequent revenue deficiencies of which have heretofore been made good by

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[1] See, for example, MCI, pp. 15-18; Sprint, p. 50.

[2] MCI p. 10.

[3] Under this reasoning, MCI should be willing to set its retail rates at its forward looking costs only. Yet MCI has not offered to do that and we suspect would vehemently resist such a pricing scheme.

[4] This is particularly true when forward looking costs are to be determined on a model such as Hatfield which theorizes costs based on a hypothetical network.

[5] Sidak and Spulber, Reply Affidavit; Schmalensee & Taylor Reply Affidavit; Kahn Statement; all attached to USTA Reply Comments.

contributions incorporated in the prices of such services as interexchange access, toll and vertical services such as local usage and custom calling;

b. ongoing costs of the LECs to the extent their actual prudently incurred incremental costs of providing individual services or unbundled network elements exceed those of a hypothetical network;

c. ongoing fixed and common costs, including overheads, such as, in industries characterized by widespread economies of scale and scope, efficient competitors must recover in charges above incremental costs if they are to continue in business; and

d. sunk costs, taking the form of a return on and of assets whose costs have not yet been fully recovered."[6]

Drs. Kahn and Tardiff go on to explain that the "absolutely fundamental fact that the critical determinant of the opportunity for competitive entry is not the level of the charge entrants pay incumbents for an essential input but the margin between it and the prices of the competitive services. Consequently, a pricing method that permits markups in the charges for network elements or other inputs could not in itself constitute a barrier to efficient entry."[7]

The IXCs argue that consumers will benefit from lower long distance prices if access prices are reformed. They fail to adequately explain why the 63% drop in intrastate access prices in California over the last 5 years did not result in correspondingly lower long distance prices. The Bureau of Labor Statistics reports that long distance prices increased 3.7% in 1996. Despite this, MCI talks about declining prices,[8] but that is not what it proves. Instead of measuring changes in actual prices, which consumers as well as economists would do to measure changes in purchasing power, MCI measures something it calls "revenues per minute." But "revenues per minute" aren't prices. Prices can be rising even as "revenues per minute" fall.

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[6] Kahn and Tardiff, attached to the Reply Comments of Bell Atlantic in CC Docket 96-98, filed May 30, 1996, p. 2. See also, Statement of Alfred Kahn, attached to USTA Reply Comments.

[7] Id. p.12 footnote omitted, emphasis original.

[8] See also MCI White Paper, Competition In the Long Distance Market, dated Jan. 27, 1997.

For example, consider a customer who switches from paying list price (in industry jargon, "MTS") to a volume discount plan with rates that are discounted 10% from MTS rates. Assume the consumer starts out paying for 100 minutes per month at $.20 each; then shifts to a discount plan that costs her $.18 per minute. Revenues per minute fall 10%, but prices stay the same. In fact, MCI could raise its MTS rates by any amount less than 10% (or whatever the amount of the discount), and for that customer, its revenue per minute would still fall. (Assume the consumer starts out paying for 100 minutes per month at $.20; then MCI raises its undiscounted price to $.21; then the consumer shifts to a 10% discount plan that costs her about $.19 per minute. Revenues per minute fall about 5%, even though prices have risen about 5%.)

This isn't an isolated paradox designed to prove that "revenues per minute" *might* be misleading because they aren't the same as prices. It's exactly what's happened in the long distance market. It's why MCI has chosen to measure "revenues per minute," not prices. Overall, prices since 1990 haven't been reduced. They've been *restructured*, with deep rate discounts going to large business customers who have the option of building or leasing their own private networks. For the majority of consumers, who aren't on discount plans, prices have risen. Measuring "revenues per minute" instead of prices disguises both the overall increase in prices and the shifting of the price burden to the majority of consumers who don't get discounts. List prices have gone up about one-third since 1991. According to testimony in California, 55% of AT&T's customers pay list price.[9]

AT&T also tries to prove that consumers are harmed with current access prices. As Schmalensee & Taylor illustrate, AT&T's claims are misleading, and do not withstand scrutiny.[10]

The Commission should not be misled. Access price reductions do not lead to lower prices for consumers.[11] Not until true competition exists in the long distance market (i.e.,

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[9] Application of Pacific Bell Communications for a Certificate of Public Convenience and Necessity to Provide InterLATA, IntraLATA, and Local Exchange Telecommunications Services Within the State of California, Application 96-03-007, Tom Long (for TURN) for cross-examination, Dec. 19, 1996, p. 1205.

[10] Schmalensee & Taylor, p. 8.

[11] "That is why AT&T has been raising its basic rates in the past couple of years, and why rivals have been following in lock step. They aim to offset a falloff in revenue brought about by

when BOCs are allowed into long distance) will consumer welfare increase. In California, AT&T's rate of return soared to 80% as a result of our intrastate access reductions. That is not the model the Commission should adopt. Instead, it is another example of our competitors trying to prescribe an access rate which cripples us but allows them to pocket huge profits.

II. ALTERNATIVES PROVIDE SUFFICIENT MARKET CONSTRAINTS ON PRICING

Alternative sources of switching and transport abound. As we illustrated in our comments, competition is thriving in California. Unbundled elements, resale opportunities, competitive access providers, collocation cages, interconnection agreements are all ways our competitors are winning customers and/or access minutes from us. While our competitors are trying to hamstring us by proposing that no pricing flexibility be granted prior to facilities based competition,[12] these same competitors oppose an adequate universal service fund to enable facilities-based competition to thrive. Instead, while using resale and unbundled elements to take our most profitable customers, they point to the holy grail of facilities-based competition as the watershed that must be met before the LECs can truly compete in the market. By taking positions and advocating policy intended to deter investment in the network by new providers, and then requiring facilities-based competition as the trigger, our competitors are trying to hoodwink the Commission into making this a one-sided game.

The Commission and the courts have recognized that "dominant firms must be allowed to engage in the rough and tumble of competition."[13] For the last 5 years, we've watched competitive access providers, and IXCs take much of our most lucrative business.[14] We must be permitted the flexibility to meet that competition and to have the tools we need to win customers

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discounting. Consumer watchdogs have long decried the fact that more than half of AT&T's 80 million household customers still pay high basic rates, apparently unaware of , or uninterested in, cheaper plans.", "Best Phone Discounts Go To Hardest Bargainers," Wall Street Journal, February 13, 1997, p. B1.

[12] AT&T, p. 87; Time Warner, p. 26.

[13] *In re Applications of Pacific Telesis Group and SBC Communications, Inc. For Consent to Transfer Control of Pacific Telesis Group and its Subsidiaries*, Report No. LB-96-32, *Memorandum Opinion and Order*, released January 31, 1997, n. 82. ("*Merger Decision*")

[14] For example, Pacific now has only 48% of the overall intraLATA toll business market. Our market share of the total California 800 market has dwindled to 4%.

back to our network. Our competitors target our best customers. MCI has recently announced it is targeting mid to large-sized business customers for its local service offering in San Francisco.[15] AT&T also is targeting business customers in California through resale of Pacific's network.[16] The presence of this competition as well as the ability of competitors to purchase unbundled elements (reducing a competitor's sunk costs astronomically) must lead the Commission to the conclusion that market based reform is proper. More particularly the presence of an approved SGAT or interconnection agreement demonstrates that entry costs are reduced and that competition can thrive.

The competitive threat we face is clear and ever present. In our comments, we presented a matrix to be used to evaluate the presence of competition to justify the removal of services from price caps in certain geographies. Many commenters argue that substantial competition isn't present, and won't be present for many years. Our experience belies this notion.

Summary of Access Competition

Geographic Area	Number of Competitive Fiber Networks	Number of Collocation Cages	Number of Cross-Connects (DS1 equiv)
Statewide	28 (5,300 Fiber Miles)	208	20,701

Status of Local Competition

Geographic Area	Local Inter-connection Trunks (DSO)	Local Usage Exchanged (MOU per mo.)	Number of NXX Codes Opened by CLCs	Services Offered By CLCs		
				CLC local switching (Y/N)	Resale lines in service (Y/N)	Unbundled loops in service (Y/N)
Statewide	20,074	103,000,000	548	Y	Y	Y

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[15] MCI Launches Local Service in San Francisco; Move Keeps MCI Ahead of AT&T in California's $10.5 Billion Local Service Arena, PR Newswire, February 4, 1997.

[16] AT&T is California Dreaming, CNN fn, January 27, 1997.

As an illustrative example, Pacific Bell proposes to submit the following evidence to meet Phase 2 triggers for the San Diego geographic area (see map on next page). The area Pacific Bell proposes to remove from price cap regulation for the San Diego metropolitan area is a small geographic area, only 12 miles by 16 miles, but highly competitive and dense.

Summary of Access Competition

Geographic Area	Number of Competitive Fiber Networks	Number of Collocation Cages	Number of Cross-Connects (DS1 equiv)
San Diego*	5 (800 Fiber Miles)	31	3,336

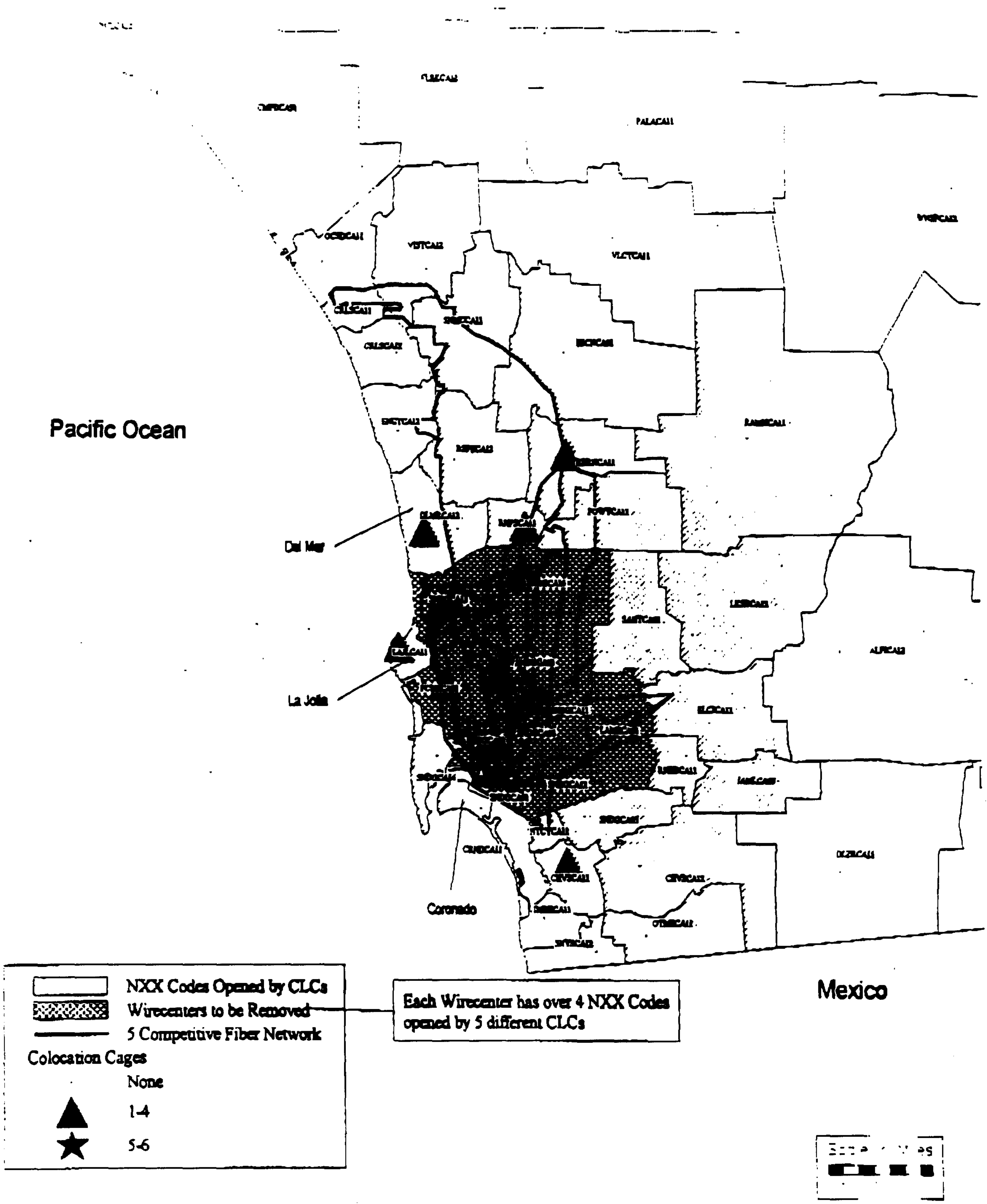
* Includes the following wirecenters: SNDGCA01, SNDGCA02, SNDGCA03, SNDGCA06, SNDGCA11, SNDGCA12, SNDGCA15, SNDGCA16, LAMSCA01, PCBHCA01

Status of Local Competition

Geographic Area	Local Inter-connection Trunks (DSO)	Local Usage Exchanged (MOU per mo.)	Number of NXX Codes Opened by CLCs	Services Offered By CLCs		
				CLC local switching (Y/N)	Resale lines in service (Y/N)	Unbundled loops in service (Y/N)
San Diego*	2,914 by 5 different CLCs	12,000,000	56 by 5 different CLCs	Y	Y	Y

* Includes the following wirecenters: SNDGCA01, SNDGCA02, SNDGCA03, SNDGCA06, SNDGCA11, SNDGCA12, SNDGCA15, SNDGCA16, LAMSCA01, PCBHCA01

This number of cross-connects in the San Diego area has the capacity to carry more than double Pacific Bell's switched access traffic. Today, in just this small geographic area, there are 5 facility-based companies competing with Pacific Bell for both access traffic and local exchange traffic. Over the past several years, Pacific Bell has lost a large amount of access traffic to the



Pacific Ocean
Del Mar
La Jolla
Coronado
Mexico
NXX Codes Opened by CLCs
Wirecenters to be Removed
5 Competitive Fiber Network
Colocation Cages
None
1-4
5-6
Each Wirecenter has over 4 NXX Codes opened by 5 different CLCs

CAPs. As the Commission may note, Pacific presented an ex parte last March showing a large amount of lost traffic, including AT&T's moving half of its DS3 traffic to a CAP. Several more facility-based companies plan to enter this geographic market in addition to the numerous resellers who already are providing service.

Pacific Bell proposes to remove all Special Access services, Switched Access Transport and Switched Access services from price cap regulation for the San Diego metropolitan geographic area noted above. In so doing, we would identify the base period demand for these services and remove it from the total base period demand within the associated service band(s). Neither the API nor the SBI would change for the remaining services/geographies when the demand quantities are removed from the API and SBI calculations. The same upward and downward pricing flexibility is afforded to services/geographies remaining under price cap regulation. No changes are needed to Part 61 rules, as this can be accomplished within the existing price cap structure.

III. ACCESS CHARGES MUST BE APPLIED ON UNBUNDLED ELEMENTS

The California Public Utilities Commission authorized us to charge intrastate and interstate access charges on toll and interLATA calls when CLCs purchase unbundled elements. Specifically, it authorized us to charge the TIC and where indicated the CCLC (there is no CCLC in our intrastate access charges). In addition, an unbundled switching element purchaser will also be charged the access transport rates when using the unbundled switch for access purposes. Our arbitrated agreements with AT&T, MCI and Sprint as well as those negotiated interconnection agreements which include unbundled elements contain these terms. In order to comport with the Communications Act, and the Commission's own precedent, the Commission must determine that these particular access charges do apply. To the extent that these access charges are not permitted to be assessed directly on unbundled elements, the Commission must permit recovery through the universal service fund.

Section 202(a) of the Act states that "It shall be unlawful for any common carrier to make any unjust or unreasonable discrimination in charges, practices, classifications, regulations, facilities, or services for or in connection with like communications service, directly or indirectly, by any means or device...." An inquiry into whether a section 202(a) violation has occurred involves a three step inquiry: (1) whether the services are "like"; (2) if they are, whether there is a price difference between them; and (3) if there is, whether that difference is reasonable.[17]

The first step, likeness, depends upon functional equivalence, which "focuses on whether the services in question are different in any material functional respect. We have said in applying this test that the FCC must look to the nature of the service offered and determine if customers perceive them as performing the same functions."[18] "If a user perceives the services as the same with cost considerations being the sole determining criterion, then the services are 'like.'"[19] Unbundled elements are considered functional equivalents for access service, under the FCC's proposal in ¶54 of the Notice. The FCC reasons that the 1996 Act permits carriers to purchase "unbundled network elements from incumbent LECs to use those elements to provide all telecommunications services to customers, including access in order to originate and terminate interstate calls."[20] Functionally, then, unbundled elements can be used for exactly the same purpose as access--to originate and terminate calls. The same network is involved in the process--the local loop, the switch and transport. The Commission recognizes that "whether traffic originates locally or from a distant exchange, transport and termination of traffic by a particular LEC involves the same network functions."[21]

Using the court's test of customer perception, it is clear that an access customer will look at unbundled elements as a substitute for access. These customers can choose whether to buy access, unbundled elements, or resale for any given customer or location. AT&T admits that access elements, like their network element counterparts "correspond, to a great extent to discrete network facilities. The facilities and functionalities are the same, and what works for one will work for the other."[22] The determining factor for the carrier customer will be price.

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[17] *MCI v. FCC*, 842 F.2d 1296 (D.C. Cir. 1988).

[18] *MCI v. FCC*, 917 F.2d 30, 39 (D.C. Cir. 1990) [footnotes and quotation marks omitted.]

[19] *Comptel v. FCC*, 998 F.2d 1058, 1061 (D.C. Cir. 1993).

[20] Notice ¶54.

[21] Notice ¶9

[22] AT&T Comments, pp. 24-25.

Thus, as functionally equivalent services, they meet the definition of like services under section 202(a).

The second prong of the test, that there is a price difference, is met since the Commission is proposing to charge one set of charges for unbundled elements, and another set of charges for access. And, the Commission is proposing to not allow interstate access charges on unbundled elements.

The final question is whether the price difference is reasonable. It is not. Carriers who purchase unbundled elements are excused, under the Commission's proposal, from contributing to the assigned interstate costs of access, and the interstate costs of the loop contained in the SLC. The Commission cannot require the same service to be priced at two different points while at the same time purporting to set up a competitive market.

Put another way, by permitting a carrier to buy a substitute service at a lower price than a functionally equivalent service, particularly when the lower priced service does not allow us to recover legitimate costs, the Commission is not only sanctioning a violation of section 202 (a) of the Act, but is also engaging in a unconstitutional taking of our property.

From a policy perspective, also, our retail products should not be burdened with a subsidy contribution that is not also included in our wholesale products. Access charges should be applied to unbundled elements in order to avoid an inequitable tax on our retail product. If the subsidy contribution is collected only from customers that choose to remain the retail customer of the ILEC, it amounts to a tax on the retail provision of service by the ILEC. Even though the tax is not applied to retail service, it is applied to IECs only if the retail services are purchased from the ILEC. Failure to do so, will result in the eventual loss of subsidy and will artificially push customers from ILEC retail services to CLEC services.[23]

IV. THE HATFIELD MODEL SHOULD NOT BE USED TO SET ACCESS PRICES

As we've stated in many other dockets, the Hatfield model provides an ill-conceived and inequitable methodology for determining costs and/or setting prices. On January 9, 1997, at the proxy model workshops, USTA submitted a report by Christensen Associates

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[23] See Rex Mitchell Analysis of Subsidy, attached, for further explanation.

entitled "Economic Evaluation of Proxy Models for Determining Universal Service Support." This report debunks many of the myths of the Hatfield model. In addition, we are attaching to these Reply Comments, excerpts from the testimony of Bruce L. Egan of INDETEC International, which was submitted by Pacific Bell to the CPUC in the MCI arbitration proceeding on September 24, 1996. This testimony presents significant evidence as to the shortcomings of the Hatfield model.

V. AT&T'S PROPOSED PRESCRIPTIVE APPROACH SHOULD NOT BE ADOPTED AS A LEGAL OR PRACTICAL MATTER

A. AT&T's Proposal Presents Significant Legal Problems

Pacific's opening comments urged the Commission to reject any proposed prescriptive approach to access charge reform, citing the significant legal and practical problems associated with such an approach.[24] In particular, Pacific noted that a prescriptive approach based on forward-looking cost principles would lead to unreasonable and uneconomic access charge rates, effect an unconstitutional taking of ILEC property, contradict established price cap policies, and place a tremendous burden on the Commission and ILECs.[25]

As expected, AT&T and other large IXCs, seeking to maintain constraints on ILECs' competitive flexibility, urged the Commission to be heavy-handed in regulating access charges and offered several variations on the Commission's prescriptive proposals.[26] Proposing its misnamed "competitive pricing" approach, AT&T claims that it would be "arbitrary not to immediately reinitialize access price caps to approximate the forward-looking, cost-based rates that would prevail in a competitive market."[27] To establish this "competitive" pricing model, AT&T proposes that the Commission revise its existing price cap structure by "borrowing" state

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[24] Pacific Comments 28-43.

[25] *Id.* 31-33, 36-39.

[26] AT&T Comments 21-28; CompTel Comments 14-22; MCI Comments 7-13; Sprint Comments 49-52.

[27] AT&T Comments ii.

TSLRIC-based unbundled element rates for "key" access elements and then "translate the new forward-looking cost estimates . . . into price cap reductions."[28]

Any such proposed prescriptive approach would result in unlawful rates and effect an unconstitutional taking of ILEC property. While AT&T asserts that the problem of unrecovered costs is "illusory," Pacific and others demonstrate that such a problem does in fact exist and that neither the Commission nor AT&T can ignore it.[29] Further, AT&T's proposed "waiver" process is inadequate to address underecovery concerns because it seeks to postpone the determination of proper cost recovery, which must be made in this proceeding in conjunction the adoption of a revised pricing structure. Accordingly, the Commission should reject AT&T's proposal and any other method that does not establish rational pricing levels for access services based upon cost plus a reasonable profit.

In addition, the Commission should reject AT&T's proposal because it would reverse existing price cap policies without adequate justification. The Commission established the price cap structure using then-existing element rates, which it determined to be the "most reasonable basis" for instituting its price cap structure, and the Commission has upheld the lawfulness of such rates since that time.[30] Other ILECs join Pacific in cautioning the Commission against departing from the existing system, without a reasoned and sufficient policy justification, in order to remain consistent with its earlier determinations.[31] Accordingly, because no policy justification exists which could support a drastic departure, the Commission should reject AT&T's proposed approach.[32]

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[28] AT&T Comments 22-29. Similarly, claiming that a prescriptive approach is the "quickest and easiest route" to reform access charges and increase competition, MCI supports requiring ILECs to reinitialize price cap indices. MCI Comments 9; 18-28.

[29] Pacific Comments 35-37, 44-49; *see also* SNET Comments 25-26; SWBT Comments 47-48.

[30] *See, e.g., In the Matter of Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786, 6814-17 (1990).

[31] *See* Pacific Comments 37-39; BellSouth Comments 44-49 (explaining that the FCC lacks legal authority to reinitialize price cap indices without first expressly finding that existing charges are unlawful); US WEST Comments 44-46.

[32] *See Greater Boston Television Corp. v. F.C.C.*, 444 F.2d 841 (D.C. Cir. 1970).

Further, AT&T fails to demonstrate adequately how its proposal addresses the need to incorporate both separations reform and universal service reform into any revised access charge system. Numerous commenters reiterate Pacific's concern that separations reform and universal service support mechanisms are important elements of any access reform effort.[33] Accordingly, the Commission cannot adopt any approach that attempts to reduce the amount of costs to be recovered under access charges without modifying the current separations process through a Joint Board pursuant to Section 410 of the Communications Act.

B. The Record Indicates the Practical Problems Inherent In Any Prescriptive Approach

Numerous ILECs joined Pacific in explaining the practical problems that would accompany any proposed prescriptive alternative.[34] For example, GTE pointed out that a prescriptive approach would place a substantial burden on the Commission and ILECs because the FCC would be required to develop complex cost studies and parties would have to "produce and agree upon an enormous amount of cost data."[35] Similarly, SNET explained that a prescriptive approach would present implementation difficulties and would be inconsistent with a competitive market.[36] Finally, the Illinois Commerce Commission expressed concern that the FCC's proposed prescriptive approach would "launch regulation on the slippery slope of administratively burdensome micromanagement."[37]

AT&T's proposal confirms the concerns of many parties that a prescriptive approach would be impracticable. Though AT&T claims that its proposal is "easily manageable" by targeting only a few "key" elements, the details of its plan point to the opposite conclusion. For example, AT&T does not adequately explain how selecting particular rate elements (when AT&T in fact acknowledges the variation in several such rates) and "translating" these rates to

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[33] *See, e.g.,* US WEST Comments 50; Illinois Commerce Commission Comments 25 (noting that attempting to address access reform without addressing separations will lead to "convoluted solutions such as the ill-advised prescriptive approach"); NARUC Comments 7 (explaining that universal service reform must be considered together with access charge reform).

[34] *See, e.g.,* Ameritech Comments 48-49; GTE Comments 66, 74-79; SNET Comments 22-24.

[35] GTE Comments 75.

[36] SNET Comments 22-24.

[37] Illinois Commerce Commission Comments 5, 24.

price cap modifications will be "easily manageable." Indeed, AT&T acknowledges that it would "in all cases" support "limited Commission review procedures" designed to ensure that rate elements are based on forward-looking costs and "broader review" where a state's determination falls outside of "some pre-established proxy range."[38] Moreover, AT&T urged the Commission to commence a new proceeding to determine the proper "metric" for determining when and if price cap regulation should be eliminated.[39]

The Commission should reject modifying its price cap regulatory system in the manner proposed by AT&T. In its *Price Cap Proceeding*, the Commission wisely agreed with AT&T and others that conducting a separate ratemaking inquiry to determine initial rates would be administratively burdensome and unnecessary.[40] The same conclusion is warranted here for even more compelling policy and legal reasons. The delays and burdens associated with adopting a prescriptive approach would deny consumers the benefits of access reform and would leave the Commission no closer to reaching a competitive-based reform of the access charge system. Any claims by AT&T or others that such a solution would lead to rapid reforms are misguided, as demonstrated by their own proposals. Accordingly, in addition to the legal infirmities noted above, the Commission should reject any prescriptive approach as unworkable and contrary to the purpose of the Telecommunications Act of 1996.

C. No Legal Precedent Precludes the Commission from Relying on Competitive Forces To Regulate Access Charges

In its comments, AT&T suggests that the Commission cannot rely on "untested competitive forces to constrain exchange access rates" because such a decision would be "arbitrary and capricious and contravene the Commission's statutory duty to ensure just, reasonable, and nondiscriminatory rates."[41] In support of this assertion, AT&T relies on

[38] AT&T Comments 27 n43.

[39] *Id.* 85-86.

[40] *See Policy and Rules Concerning Rates for Dominant Carriers*, 3 FCC Rcd 3195, 3333-40 (1988); *cf.* Reply Comments of American Telephone and Telegraph Company, CC Docket No. 87-313 (filed Dec. 4, 1987) at 28 (noting in the context of setting initial rates for AT&T price cap regulation that "[f]ar from serving any valid purpose, the extensive rate prescription proceedings urged by some commenters would result in a massive, time-consuming and costly administrative process that would only delay badly needed reform indefinitely").

[41] AT&T Comments 48.

Farmers Union Central Exchange, Inc. v. FERC.[42] However, the proposition for which this case stands is that an agency cannot abandon its responsibility to set just and reasonable rates, not that competitive forces are inadequate to discipline rates.

In *Farmers Union*, the court determined that FERC's responsibility to set just and reasonable rates for pipeline transportation did not allow it to ensure only that ratemaking protects consumers from "egregious exploitation and gross abuse"[43] or that a rise in the price of oil compared to pipeline transportation excused FERC from its mandate to regulate rates. In addition, the court criticized FERC for relying on competition to hold rates down with no finding that market forces would actually limit such prices.[44]

Here, the Commission has not proposed to take any of the actions criticized by the court. First, the Commission has not proposed to take any action which abandons its statutory mandate to set just and reasonable rates. The Commission has instituted this proceeding to adjust the structure of access charges in light of the passage of the Telecommunications Act, in which Congress determined that competition, rather than regulation, should be used to determine rates for telecommunications services.[45] In fact, the Commission states that its "goal is to end up with access charge rate structures that a competitive market for access services would produce."[46] Clearly, the Commission fully understands its responsibilities under the Act.

Second, the Commission has proposed a market-based approach which relies "on potential and actual competition from new facilities-based providers and entrants purchasing unbundled elements to drive prices for interstate access services toward economic cost."[47] In the Act, Congress has demonstrated its strong desire for competitive telecommunications markets by revising existing rules to ensure competition in all markets. In adopting a market-based approach, the Commission is relying on a new statute with a new purpose. In addition, increasing competition in local markets around the country, of which California is an excellent

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[42] 734 F.2d 1486 (D.C. Cir. 1984), *cert. denied, Williams Pipe Line Co. v. Farmers Union Central Exchange, Inc.*, 469 U.S. 1034 (1984).
[43] *Id.* at 1502.
[44] *Id.* at 1509.
[45] *NPRM*, ¶ 5.
[46] *Id.* at ¶ 13.
[47] *Id.* at ¶ 14.

example, demonstrates that reliance on market forces to regulate access charges would not be misplaced and would be consistent with Congressional intent. Therefore, the case on which AT&T relies to show that the market-based approach is arbitrary and capricious is not relevant to this Commission's decision.[48]

D. The Commission Must Allow ILECs the Opportunity To Fully Recover Their Costs

As Pacific Telesis demonstrated in its comments, recovery of ILEC historical costs is required by the Communications Act and the Takings Clause of the Constitution. Pacific Telesis explained that there is a regulatory compact between regulators and regulated entities.[49] Under this compact, regulators must allow regulated entities the opportunity to recover the costs forced upon it by regulation. Prior to the 1996 Act, the Commission and state PUCs created a regulatory regime under which ILECs were, and still are, required to charge below-cost residential rates only partially funded through subsidies from other services and other deferred cost recovery, such as deferred depreciation. In addition, ILECs were, and still are, required to serve as a carrier of last resort. The subsidies to support these regulatory mandates came from a variety of sources, including an over-allocation of joint facility costs to long distance services and above-cost access charges.

In the 1996 Act, Congress has shown its intention that all telecommunications markets, including local and long distance services, should be competitive with hidden subsidies that distort competition removed. However, in restructuring its regulations, the Commission cannot ignore the costs it has imposed on ILECs. Providing below-cost services and serving all customers has left ILECs with substantial unrecovered costs from expenditures that were required by the Commission and state PUCs. Ignoring these costs will both violate the Takings Clause and thwart competition.

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[48] AT&T also relies on *Coal Exporter's Ass'n v. U.S.*, 745 F.2d 76 (D.C. Cir. 1984). However, in this case, the court determined that the ICC did not find before granting an exemption from regulation that there would be an absence of "market power" and the presence of "effective competition," as required by the Staggers Act. Since no such requirement applies to access charges, this case is also unrelated to the Commission's decision.

[49] Pacific Comments 44-52.

Pacific fully supports the Commission's efforts to remove hidden subsidies and ensure a regulatory level playing field which will promote competition and benefit consumers. However, reneging on its commitments by forcing ILECs to bear the costs of this change in regulatory structure will not further either of these goals. Numerous other commenters also recognize that the regulatory compact exists, have cited significant cases confirming its existence, and agree that forcing ILECs to bear these costs would violate this compact and, thus, work an unconstitutional taking of property.[50]

MCI nonetheless denies the existence of such a compact, arguing that courts have held that the Commission need not allow recovery of all costs so long as the financial integrity of the regulated entity is not threatened and its ability to attract capital is not impeded.[51] To support its claim, MCI cites *Illinois Bell Tel. Co. v. FCC*. However, this case does not undermine, but in fact supports, Pacific Telesis's arguments.

In *Illinois Bell*, the court stated that "there simply has been no demonstration that the FCC's rate base policy threatens the financial integrity of the RHCs [Regional Bell Holding Companies] or otherwise impedes their ability to attract capital."[52] The court also noted that "Ameritech makes only an unsupported and unexplained assertion" as to the extent of its potential losses.[53] Pacific Telesis fully understands the constitutional standard reiterated in *Illinois Bell* and has demonstrated in this and numerous other proceedings that the facts here undeniably satisfy that standard. Pacific's financial integrity and its ability to attract capital will be threatened if the Commission does not establish coordinated separations, access charge, and universal service mechanisms which give ILECs the opportunity to recover their costs.

The Commission's TSLRIC and TELRIC-based pricing do not include all existing costs, but rather are based on a hypothetical network which is necessarily more efficient than any existing network, because no ILEC immediately retires all operating equipment as soon as more efficient equipment is available. Forcing ILECs to use this standard for pricing of

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[50] *See, e.g.*, U S West Comments 75-83; United States Telephone Association Comments 68-81; Citizens Utility Company Comments 44-48

[51] MCI Comments 31-32.

[52] *Illinois Bell Tel. Co. v. FCC*, 988 F.2d 1254, 1263 (D.C. Cir. 1993) (citations omitted).

[53] *Id.*

interconnection, unbundled elements and access charges will thus not allow an opportunity to recover costs already incurred. Such pricing will, instead, force ILECs to either sustain heavy losses in providing services to customers or allow CLCs to "pick off" the most profitable customers. In either case, the ILECs' financial integrity will be at risk.

Prior to the 1996 Act, ILECs were able to recoup losses in one area of regulated activity, such as from below-cost local rates, from another, such as above cost business rates. However, under the scheme laid out in the 1996 Act, these subsidies must be eliminated. As a result, ILECs will have no other mechanisms available for recouping the very substantial costs formerly deferred, and collected through access charges. USTA estimates that the unseparated reserve catch-up for Pacific Telesis is $2.3 billion and that its interstate reserve catch-up is $524 million. However, as Pacific Telesis's own filing indicates, these numbers are conservative.[54]

It follows that not allowing ILECs the opportunity to recover reasonable incurred costs will prevent them from attracting capital. ILECs have invested in their networks (often to provide below-cost services) on the basis of the Commission's and state PUC's approval of certain expenses and have attracted capital on the basis that these expenditures will be recouped through their regulated rates. If the Commission changes its recovery rules now, investors will not be willing to invest further for fear that the Commission will "change the rules" again and lower the value of their investment. To ensure that ILECs are able to compete with CLCs in attracting capital, which ILECs will need to do to compete effectively, the Commission must ensure that they have an opportunity to recoup their investments in their networks.

AT&T agrees with Pacific regarding the applicable standard, but argues that because of a variety of factors ILECs may not suffer shortfalls if not allowed to recover their historical and other costs through an express access charge mechanism and further alleges that these shortfalls are overstated.[55] Pacific Bell has provided conclusive evidence of its non-recovered costs before both this Commission and the CPUC. AT&T's generalized claims to the contrary, which are supported almost entirely by AT&T affidavits, are without probative value. Similarly, AT&T's claims that the ILECs' financial integrity will not suffer is absurd,

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[54] United States Telephone Association Comments, Attachment 13.

[55] AT&T Comments 31-33.

particularly in light of the fact that in support of this claim they cite reports indicating that ILECs will compete in the long distance market.[56] Considering that AT&T is using its best efforts to prevent ILECs from entering the long distance market, and that the Commission's detailed separation rules prevent cross-subsidies between a BOC and its interLATA affiliate,[57] AT&T's reliance on interLATA or any other service to provide Pacific with its necessary recovery is wholly unfounded.

E. The ILECs Cannot Engage in a "Price Squeeze"

AT&T maintains that current access rates are excessive and that ILECs can, therefore engage in a "price squeeze" to harm competitors.[58] The Commission has already disposed of this "price squeeze" red herring, recognizing that "under the provisions of the 1996 amendments to the Communications Act new entrants or other competitors would be able to defeat that [price squeeze] scheme."[59] The Commission found "that an attempted price squeeze is unlikely to be an effective anti-competitive tool" because competitors can purchase unbundled network elements and resale of retail services.[60]

A true price squeeze would occur only if the price charged by the BOC's interexchange affiliate were less than the BOC's marginal cost of access, plus the foregone contribution from that access, plus the cost to the BOC's affiliate of providing the long distance service. It would be irrational for the BOC's interexchange affiliate to price below this level unless its object was predation. But a predatory strategy would make no sense because of the excess capacity in the interLATA market, which means that as soon as a would-be predator had driven competitors out of the market and raised prices to supracompetitive levels, competitors could easily re-enter the market.

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[56] *Id.* at 38 n.65.

[57] 47 C.F.R. Part 36.

[58] AT&T Comments 14-17.

[59] Applications of Pacific Telesis Group, Transferor, and SBC Communications, Inc., Transferee, for Consent to Transfer Control of Pacific Telesis Group and Its Subsidiaries, Report No. LB-96-32 ¶ 54 (FCC 97-28, released January 31, 1997).

[60] *Id.*

In any event, the imputation required by section 272(e)(3) of the Act, forecloses the possibility of a price squeeze. As the Commission held in CC Docket No. 96-149:

> a section 272 affiliate's purchase of ... exchange access at tariffed rates, or a BOC's imputation of tariffed rates, will ensure compliance with section 272(e)(3). If a section 272 affiliate purchases ... access at the highest price that is available on a nondiscriminatory basis under tariff, section 272(e)(3)'s requirement that a BOC must charge its section 272 affiliate an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carrier will be fulfilled.[61]

AT&T is also wrong in suggesting that ILEC purchase of unbundled network elements would enable them to avoid imputation. The Commission determined that if a BOC affiliate were to acquire on a nondiscriminatory basis services or unbundled elements from a BOC under section 251, or pursuant to a statement of generally available terms filed pursuant to section 271(c)(1)(B), it would be in compliance with the imputation requirements of section 273(e)(3).[62]

AT&T's "price squeeze" contention also assumes behavior that would not be profit-maximizing for the BOC. Because of the imputation rule in §272(e)(3), the BOC's interLATA affiliate gains no cost or price advantage over its rivals when its BOC raises access prices.[63] Thus,

[61] *Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended*, CC Docket No. 96-149 ¶ 256 (FCC 96-489, released Dec. 24. 996) ("*Non-Accounting Safeguards Order*"). To record imputed exchange access charges required under section 272(e)(3), BOCs must debit the nonregulated operating revenue account by the amount of the imputed exchange access charges and credit the regulated revenue account by the amount of the imputed exchange access charges. Where a BOC charges different rates to different unaffiliated carriers for access to its telephone exchange service, the BOC must impute to its integrated operations the highest rate paid for such access by unaffiliated carriers. *Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-150 ¶¶ 87-88 (FCC 96-490, released Dec. 24, 1996)

[62] *Non-Accounting Safeguards Order* ¶ 256.

[63] The CPUC has an imputation standard that is similar in its objective to the imputation rule of §272(e)(3). Pacific Bell is required to impute to its own operations the contribution that